

Constant Dollar vs. Current Cost Indexing. Two conceptually distinct approaches to indexing depreciation deductions for inflation--constant dollar and current cost--have been suggested. Constant dollar indexing of depreciation would adjust depreciation deductions to reflect changes in the general price level. It is the type of indexing just described and is the depreciation analog of the capital gains and interest income indexation described earlier in this chapter. Current-cost indexing of depreciation would base each year's depreciation on the current cost of purchasing each particular asset.³⁶ Current-cost indexing would represent a marked departure from standard tax accounting and would treat depreciable assets differently from other capital assets.³⁷ Moreover, it would pose practical

³⁶ For a good discussion of the differences between current-cost and constant-dollar indexing and the theoretical and practical strengths and weaknesses of the two approaches, see Arthur Young and Company, Financial Reporting and Changing Prices: A Survey of How 300 Companies Complied with FAS 33 (August 1980); and Financial Reporting and Changing Prices: A Survey of Preparers' Views and Practices (August 1981).

³⁷ Traditionally, depreciation was intended to account for declines in asset values due to physical deterioration and, to a lesser extent, to obsolescence. Current-cost depreciation reflects changes in the current cost of purchasing an asset--changes brought about not only by deterioration and obsolescence, but by other factors as well, such as changes in the demand for and supply of the asset itself and the goods it is used to produce.

Under an income tax, in theory, owners of businesses should be taxed each year on changes in the real value of plant and equipment, no matter what the underlying cause. Whether a decrease in the real value of a machine is brought about by physical wear and tear, obsolescence, or a decrease in demand for the final product, the firm should subtract this decrease in real value from its receipts in calculating the income on which tax is due. Since this kind of accrual taxation requires annual valuation of all of the nation's plant and equipment, it is not administratively feasible. The tax system approximates it by allowing annual depreciation deductions and makes up for any errors caused by this approximation by taxing gain on sale. For tax purposes, the value of an asset at any point in time is considered to be its adjusted basis. If an asset is sold for more than its adjusted basis (for instance, if a fully depreciated asset is sold for any positive price), the tax system in effect recognizes that depreciation deductions exceeded the decline in the asset's value and charges tax on the difference between sale price and adjusted basis. (Continued)

problems, particularly for tax accounting, because of the difficulty of objectively determining current costs.³⁸

Depreciation Schedule to Be Indexed

Any schedule of depreciation deductions can be indexed for inflation so that the real value of the deductions does not change with inflation, but, logically, indexation should be superimposed on the depreciation schedules that would be preferred in the absence of inflation. Since depreciation schedules have been accelerated since 1954 and were further liberalized in 1962, 1971, and 1981 in part to offset the effects of inflation, the Congress might want to revamp the entire depreciation system if it indexed the tax base.³⁹

At rates of inflation now predicted for the next few years, the current depreciation system is more generous than a system of true

Relative price changes like those reflected in current cost, but not constant-dollar depreciation indexing, occur for all assets, not only for depreciable assets. Since nondepreciable assets, such as land, are not afforded the accrual taxation that current-cost depreciation approximates, current-cost depreciation would make the taxation of depreciable assets unique. A study devoted to a comparison of current-cost and constant-dollar depreciation indexing concluded ". . . in absence of accrual accounting for all changes in value of assets, it will be found that depreciation based upon replacement cost leads to a worse measure of income than does depreciation adjusted for overall changes in the price level." (Eugene Steuerle, "Adjusting Depreciation for Price Changes," U.S. Department of Treasury, OTA Paper #37 (March 1979), p. 3.

³⁸ Constant-dollar accounting is much more straightforward than current-cost accounting. For a discussion of some of the practical problems of implementing current-cost accounting and how companies have dealt with them, see Arthur Young and Company, Financial Reporting and Changing Prices: A Survey of Preparers' Views and Practices (August 1981).

³⁹ The 1981 depreciation liberalizations were enacted primarily for three reasons: to simplify the calculation of depreciation, to encourage new capital investment, and to offset the effects of inflation on the real value of depreciation deductions. (See Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, p. 75).

economic depreciation indexed for inflation. In other words, current law allows deductions exceeding real losses in asset values during the early years of ownership. Enacting a system of indexed economic depreciation based on the true decline in the value of plant and equipment would probably, therefore, raise income taxes for businesses.

PRODUCTION GOODS USED FROM INVENTORIES

When goods are always used in production in the year purchased, inflation does not seriously distort the measurement of the cost of these goods; when goods are purchased well in advance of their use, however, inventories accumulate and inflation causes problems. If the cost of the goods used in production is taken to be the nominal amount paid for them, the true cost of production is understated and consequently income is overstated and overtaxed.

Indexing inventories for inflation would require that purchase prices of goods be translated into the dollars prevailing at the time of their use in order to measure properly the real cost of the goods. For instance, if goods are purchased for \$100 and used after two years of annual inflation of 10 percent, their cost should be counted for income tax purposes as \$121 ($\$121 = \$100 \times 1.1 \times 1.1$), rather than \$100.

Under current law, firms are not required to mark each item in inventory with its cost and date of purchase or to note precisely which items are used in production each year. Rather, they maintain ledgers listing the quantity and unit cost of inventory acquired at each date. When filing their tax returns, firms assign a cost to inventory used in production according either to the FIFO (first-in-first-out) or LIFO (last-in-first-out) approach. Under the FIFO approach, the goods used in production are assumed to have been the first put into inventory. Their cost is determined accordingly by reference to the cost of the oldest goods listed in the inventory ledger, and those goods are then scratched from the ledger. Under LIFO, the goods used are assumed to have been the last put into inventory. LIFO and FIFO produce the same results when all prices are stable.

Under FIFO, a longer time elapses between assumed acquisition and use of goods, so during inflationary periods the difference between the nominal and real value of the goods used in production is greater than under LIFO. As far as income tax accounting is concerned, the problems posed by not indexing inventories are, therefore, more acute when FIFO

accounting is used.⁴⁰ In fact, LIFO accounting roughly approximates replacement cost inflation indexing when inventories are not depleted--that is, when annual additions to inventory roughly equal the amount of inventory used in production.

During inflationary periods, constant-dollar FIFO accounting is superior even to LIFO accounting, because when inventories are being depleted and goods used in production have been in inventory a long time, even the use of LIFO accounting sharply understates the real cost of inputs. Moreover, goods in inventory could be appreciating in real terms relative to the general price level and, under LIFO accounting, that appreciation would go untaxed until the inventories were depleted. With FIFO accounting, firms are in essence taxed on the appreciation of their inventories; with constant-dollar (indexed) FIFO accounting, firms are taxed only on the real appreciation of their inventories.⁴¹

Indexing the cost of goods used in production would reduce taxable business income, and reduce it more for companies that use FIFO than for those that use LIFO. Table 15 illustrates how indexing the costs of production goods would have reduced the incomes of 209 companies in 1979.

CONCLUSION

Indexing the income tax base has much to recommend it in terms of improving the equity and efficiency of the income tax, but it would add complexity for taxpayers and the IRS.

The gains in equity and efficiency arise because only real income would be taxed. Effective tax rates exceeding 100 percent, sometimes

⁴⁰ For this reason, many firms now use LIFO inventory accounting, although many resisted changing from FIFO, both because LIFO understates the current value of inventories and worsens balance sheets and because FIFO reduces nominal income, making firms appear less profitable. If LIFO is used for tax purposes, it must be used also in financial reports to shareholders and in credit applications (I.R.C. § 472 (c)).

⁴¹ For an excellent explanation of the difference between LIFO and FIFO and of why FIFO recognizes inventory profits on accrual, see John Shoven and Jeremy Bulow, "Inflation Accounting and Nonfinancial Corporate Profits: Physical Assets," Brookings Papers on Economic Activity, vol. 3 (1975), pp. 584-590.

TABLE 15. EFFECT OF INDEXING COST OF GOODS USED IN PRODUCTION ON THE INCOMES OF COMPANIES USING LIFO AND FIFO IN 1979

Percentages by Which Indexed Income Is Lower than Nominal Income Because of Cost of Sales Indexation ^a	LIFO and Partial LIFO Companies ^b (In percents)	FIFO Companies ^b (In percents)
Over 100 percent lower	2	15
50-100 percent lower	6	9
10-50 percent lower	57	72
1-10 percent lower	25	4
No difference	10	0
Higher	<u>0</u>	<u>0</u>
Total	100	100

SOURCE: Arthur Young & Company, Financial Reporting and Changing Prices: A Survey of How 300 Companies Complied with FAS 33 (August 1980), p. 30.

- a. Cost of sales are indexed using the constant dollar technique.
- b. Sample includes 162 LIFO and partial-LIFO companies and 47 FIFO companies.

experienced under current law on real capital gains and interest income, would no longer occur. Nor would borrowing be subsidized. No longer would investment in certain industries or equipment (long-lived versus short-lived, capital intensive versus labor intensive, debt financed versus equity financed, for instance) be encouraged or discouraged simply by the interaction of inflation with the income tax. The Congress could determine how heavily it wanted to tax capital income compared to labor income and not have to be concerned that a change in the inflation rate would change the established relationship. Tax-base indexing superimposed on a neutral income tax with no preferences for saving and investment (one in which the statutory tax rate applied to all kinds of investment income) would improve the allocation of economic resources among investments.

With indexation, taxpayers would not know in advance what percentage of their nominal interest income would be taxable and what percentage of their nominal interest payments would be deductible. While their nominal tax rates would thus be more uncertain than currently, their real tax rates would not fluctuate as much with inflation as they do now.

In general, tax-base indexation might induce taxpayers to seek indexed wage contracts and interest-bearing securities in an attempt to achieve predictable real incomes and taxes. In the more completely indexed economy that could ensue, some inflation (such as that triggered by sudden increases in the price of imported oil) could be quickly transmitted throughout the economy.⁴² Tax indexing itself, therefore, might fuel inflation. On the other hand, if tax-base indexing encouraged the use of indexed interest-bearing securities, the risks associated with unanticipated inflation would be reduced for lenders. Real interest rates might then drop and there might be more of a market for long-term debt.⁴³

The cost of tax-base indexing in terms of added complexity is hard to assess. Since 1979, about 1,500 of the country's largest companies have been required to provide their stockholders supplementary income and

⁴² For the arguments that indexing may itself be inflationary, see Arthur Okun, Prices and Quantities: A Macroeconomic Analysis (Washington, D.C.: The Brookings Institution, 1981), pp. 289-296.

⁴³ See John Bossons, "Economic Effects of the Capital Gains Tax," Canadian Tax Journal (November-December 1981), pp. 819-820. Real interest rates on indexed securities might be as much as 2 percentage points below those on unindexed securities. (John Bossons, "Indexation After the Lortie Report," pp. 23-26.)

balance sheet data indexed for inflation.⁴⁴ For these companies, the mechanics of tax-base indexing would probably not be overly burdensome. For smaller companies and individual taxpayers with capital gain or

⁴⁴ Financial Accounting Statement No. 33 (FAS 33), issued by the Financial Accounting Standards Board (FASB) in 1979, requires large firms (public companies with assets exceeding \$1 billion or inventory, property, plant and equipment of more than \$125 million) to provide supplementary inflation-adjusted balance sheet and income statement data. (Prior to 1979, the SEC required that companies registered with it provide annual data adjusted for inflation in a somewhat different manner. The SEC dropped its separate requirements when FAS 33 was issued.)

The inflation indexing of FAS 33 is more onerous and comprehensive than tax-base indexing would be. FAS 33 requires that the indexing be done two ways--using both the constant-dollar and current-cost techniques--and that it be done for some additional items beyond those required for tax-base indexing. Since only the relatively straightforward and more objective constant-dollar technique would be used for tax-base indexing, and since companies covered by FAS 33 have had several years to develop procedures for constant-dollar indexing, tax-base indexing would impose little additional burden on these companies. Other companies would face substantial compliance costs, particularly in the first year of tax indexing, but they could hire financial advisers who have worked with FAS 33.

FAS 33 was instituted for five years on a trial basis, after which the FASB plans to review its requirements based on experience with the current rules. Corporate management and the financial community have generally found current-cost accounting information more useful than constant-dollar information since it provides a better measure of real profits. (However, even current-cost data are not used extensively by corporate management for internal planning or by investment analysts.) The FASB might, therefore, decide to drop the constant-dollar requirements of FAS 33 and make permanent only the current-dollar requirements, although its decision might be influenced by enactment of tax-base indexing. Moreover, the FASB recently exempted companies with a significant part of their operations in foreign countries from some of the constant-dollar requirements of FAS 33.

For descriptions of FAS 33, its history, and results based on the first year's experience with it, see Peter Hart, "Accounting for Inflation in the United States," National Tax Journal (September 1980), pp. 247-255; and Arthur Young and Company (1980) and (1981).

interest income or deductions, tax-base indexing could be quite burdensome, and the IRS' job would be undeniably more difficult. This added complexity would be partly offset by any simplification derived from simultaneous repeal of tax preferences for capital income.

Should Base Indexing Be a Package Deal?

Opinion differs widely on the desirability of indexing only some tax-base items and of indexing the tax base without repealing the tax preferences for savings and investment. For instance, some argue only for enactment of provisions that would unambiguously reduce taxes.⁴⁵ Others argue that partial indexing is undesirable because of the opportunities it would create for tax avoidance. For instance, if only interest income and not interest expense were indexed, taxpayers would be able to profit by engaging in tax arbitrage--borrowing and deducting all of their nominal interest payments and lending the proceeds and paying tax only on part of the nominal interest received. Similarly, if capital gains were indexed and interest income and expense were not, taxpayers would be able to deduct more than their real interest expense but only have to pay tax on real capital gains.⁴⁶ This would implicitly reduce the tax rate on capital gains below the statutory rate.⁴⁷

Most economists now favor base indexing only if applied to all base items and only if accompanied by repeal of the many tax incentives for saving and investment. As explained throughout this chapter, none of these tax incentives was enacted for the sole purpose of offsetting the effects of inflation, but several were enacted or expanded partly for that reason. Moreover, several were enacted to encourage investment generally--

⁴⁵ See, for example, John Mendenhall, "Tax Indexation for Business," National Tax Journal (September 1980), pp. 257-263.

⁴⁶ Indexing capital gains alone would amount to a back door way of indexing depreciation and interest income. Because this indexing would apply only to depreciable and interest-bearing assets that generate capital gains (not to savings accounts, for instance), it would not be neutral in its effects. For a good explanation, see Department of Finance, "A Review of the Taxation of Capital Gains in Canada" (Ottawa, Canada, November 1980), pp. 40-44, 57-58.

⁴⁷ The tax rate on some capital gains would even be negative. When there is no inflation, capital gains income is taxed more lightly than other income, since 60 percent of gain is excluded from taxable income.

investment that might have declined partly as a result of inflation's increasing the rate of tax on capital income.⁴⁸ To the extent that the tax incentives were enacted directly or indirectly to offset the effects of inflation, they might be repealed or scaled back if tax-base indexing is enacted. Since some of the savings and investment incentives might have been enacted for other reasons--to compensate for such shortcomings in the income tax as double taxation of corporate dividends, for example--the Congress might decide to retain them.

Revenue Effect and Distributional Consequences

The revenue effect and distributional consequences of tax-base indexing would depend on the other changes enacted at the same time and the subsequent rate of inflation. Tax-base indexing could conceivably have no effect on federal revenues if enough tax incentives for saving and investment were repealed simultaneously. Tax-base indexing superimposed on the current tax system, with its many tax preferences, would reduce federal revenues. Probably less revenue would be lost, however, if indexing was applied only to new assets.

The overall effect of inflation under a comprehensive income tax is to increase the tax burden on capital income, although the real tax burdens of individuals and businesses that borrow to finance capital investment can actually decline. If borrowers and lenders were in exactly the same tax bracket, indexation of interest income and expense would leave total revenues unchanged--the revenue lost by indexing interest income would be made up by that gained by indexing interest expense.⁴⁹ If net borrowers were in a higher tax bracket than net lenders, indexing would raise federal revenues; if borrowers were in a lower bracket, indexing would reduce revenues. In some cases, tax is not due on interest income (for instance, interest on pension fund and individual retirement account investments), although borrowers deduct the interest payments, while in other cases tax is collected on the interest paid on federal securities although there are no offsetting interest deductions. Thus, it is difficult to predict whether

⁴⁸ For a technical discussion of the negative effects on the economy caused by the interaction of inflation with the unindexed income tax in the 1960s and 1970s, see Martin Feldstein, Inflation, Tax Rules and Capital Formation (Chicago: University of Chicago Press, 1983).

⁴⁹ These and other revenue effects discussed in this section refer to the net effect on corporate and individual income taxes combined.

indexing interest income would increase or decrease federal revenues.⁵⁰ Indexing the other tax base items--capital gains, depreciation, and inventories--would significantly reduce revenues. Since it is unlikely that indexing interest income and expense would raise revenues by more than indexing the other base items would reduce revenues, the net effect of indexing would be to reduce revenues.

Tax-base indexing superimposed on the current income tax would reduce taxes for individuals with capital gain and interest income but raise them for individuals (including many homeowners) who are net borrowers. Indexing the income tax base without making any other changes in the tax would benefit recipients of capital income, who tend to have high incomes.⁵¹ Fifty-seven percent of all net capital income taxed at a positive rate in 1979 was earned by taxpayers with incomes above \$50,000, and these taxpayers paid 83 percent of the total tax paid on capital income in that year, as shown in Table 16. If the Congress indexed the income tax base, it could make up the lost revenue and maintain the current distribution of the income tax by enacting a more steeply graduated rate schedule.

Overall, with indexation of the current tax, corporations would probably pay more tax in some years and less tax in other years than under current law, again depending on the course of future inflation. The largest corporations now prepare two sets of financial statements--unindexed and indexed--and a study of 300 of these companies found that indexed net

⁵⁰ A recent study concluded that borrowers are in higher tax brackets on average than lenders and therefore that indexing interest income and expense would raise taxes overall. This result is at variance with results of earlier work, and all results are tentative since they rely on strong simplifying assumptions about how capital markets work. (Mervyn King and Don Fullerton, eds., "The United States," in The Taxation of Income from Capital (Princeton: Woodrow Wilson School of Public and International Affairs, Princeton University, Discussion Paper #37, December 1982), Section 4.1.) Federal outlays would decrease if indexing caused interest rates to drop and thus reduced the cost of paying interest on the federal debt.

⁵¹ By the same token, failure to index the tax base hurts the same group. ". . . under the present [unindexed] income tax system, increases in inflation cause an increase in taxes that is in substance identical to a graduated tax on wealth." (John Bossons, "The Effect of Inflation-Induced Hidden Wealth Taxes," Proceedings of the 32nd Tax Conference, Canadian Tax Foundation (May 1981), pp. 18-19.)

TABLE 16. DISTRIBUTION OF INCOME FROM CAPITAL REPORTED AND TAXED ON INDIVIDUAL INCOME TAX RETURNS, BY INCOME LEVEL FOR 1979^a

Expanded Income ^b (In thousands of dollars)	Total Income Tax		Net Income from Capital Taxed at a Positive Rate ^c		Tax on Capital Income ^d	
	(In billions of dollars)	Percentage Distribution	(In billions of dollars)	Percentage Distribution	(In billions of dollars)	Percentage Distribution
0-5	-0.2	---	0.0	0.0	-0.1	---
5-10	6.8	3.2	6.3	7.4	0.8	2.8
10-15	17.4	8.2	9.8	11.6	1.5	5.2
15-20	24.2	11.4	6.9	8.1	1.1	3.8
20-30	52.6	24.8	6.1	7.2	0.6	2.1
30-50	50.9	24.0	7.5	8.9	0.9	3.1
50-100	31.0	14.6	19.6	23.1	7.0	24.5
100-200	14.2	6.7	11.5	13.6	5.5	19.2
Over 200	15.7	7.4	17.0	20.1	11.2	39.2
Totale	212.5	100.0	84.7	100.0	28.6	100.0

SOURCE: Eugene Steuerle, "Is Income From Capital Subject to Individual Income Taxation?" Public Finance Quarterly (July 1982), p. 291.

- Income from capital includes dividends and retained corporate earnings attributable to shareholders, net rental income, net interest income, and one-third of proprietors' income.
- Expanded income is a broader concept of taxpayer income than adjusted gross income. In addition to adjusted gross income, it includes the excluded part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax. At the same time, it excludes the deduction of investment interest to the extent it exceeds investment income.
- Income from capital minus deductions for interest, real estate taxes, and personal property taxes.
- Difference between total tax collected and tax that would have been collected had the capital income not been subject to tax.
- Details may not add to totals because of rounding.

income for 1979 was on average 96 percent of unindexed net income.⁵² Although the total 1979 tax liability of these corporations taken together would therefore have dropped only slightly with tax-base indexing, companies in some industries would have received sizable tax cuts and others sizable increases.⁵³ Even within industries, some companies (those that rely heavily on debt financing) would have paid much more tax, while others would have paid much less.⁵⁴ Another study compared historical cost (unindexed) income (calculated using straight-line depreciation) to indexed replacement cost income for 136 companies over 1961-1980. In 13 of the 20 years studied, indexed income was less than unindexed income.⁵⁵

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- ⁵² The corporations themselves do not calculate indexed net income, but they are required to provide data that can be used to construct income figures restated to reflect the constant-dollar indexation of depreciation, costs of production goods taken from inventory, and the purchasing power gain or loss on net monetary liabilities. Although this concept of restated net income does not correspond exactly to that of indexed taxable income, it can be used to get a rough idea of the implications of tax base indexing. Arthur Young & Company used the data supplied by 300 corporations to calculate net income restated for inflation in several different ways. The statistics reported in the text and in the following two footnotes are based on the restated income concept that corresponds most closely to indexed taxable income as described in this chapter. (For a description of the Arthur Young analysis, see Arthur Young & Company, Financial Reporting and Changing Prices: A Survey of How 300 Companies Complied with FAS 33 (1980), pp. 5-20. The statistics on restated net income are found in Appendix A (pp. 52-60) under column 8, "Constant Dollar Income from Continuing Operations Plus Purchasing Power Gain or Loss on Net Monetary Assets.")
- ⁵³ For instance, the indexed net income of makers of office equipment was only 56 percent of unindexed net income, whereas the indexed net income of utilities (which are heavy borrowers) was 167 percent of unindexed net income. (Arthur Young & Company (1980), pp. 57, 60.)
- ⁵⁴ Within the group of companies manufacturing motor vehicles and equipment, for example, indexed net income as a percentage of unindexed income ranged from negative 144 percent to positive 132 percent. (Arthur Young & Company (1980), p. 56.)
- ⁵⁵ In 1964, 1965, 1975-1978, and 1980, indexed income was 7 to 13 percent below unindexed income. Differences between the two income measures were smaller in the other years. These data were prepared as background for Victor Bernard and Carla Hayn, "Inflation

Two studies compared the 1977 total tax on corporate source income (tax owed by the corporations themselves on net income, their shareholders on dividends and capital gains, and bondholders on interest income) with the tax that would have been owed had the tax base been indexed for inflation. One found that the tax on corporate source income for 1977 was \$32 billion more than what would have been due if the 1977 law had been unchanged except to require tax-base indexing. It found that the total effective tax rate on corporate-sector capital income was 66 percent in 1977, compared to the 41 percent tax rate that would have occurred had the tax base been indexed.⁵⁶ The other study found the extra tax for 1977 to be \$21 billion and the total effective tax rate for 1977 to be 54 percent.⁵⁷ Another study found that for most years during 1946-1974, corporate taxable income was higher than real (indexed) income measured on accrual.⁵⁸

Since tax-base indexing is extremely complicated and would add significantly to the burden of complying with and administering the income tax, at consistently very low rates of inflation the disadvantages of index-

and the Magnitude and Distribution of the Corporate Income Tax Burden" (University of Michigan, June 1983).

- ⁵⁶ Martin Feldstein and Lawrence Summers, "Inflation and the Taxation of Capital Income in the Corporate Sector," National Tax Journal (December 1979), p. 445.
- ⁵⁷ Jane Gravelle, "Inflation and the Taxation of Capital Income In the Corporate Sector: A Comment," National Tax Journal (December 1980), pp. 481-482. Gravelle argued that both the Feldstein/Summers study and her study overstate the effects of inflation on raising tax burdens since the Congress enacted or expanded tax preferences for capital income to offset the effects of inflation. Since 1977, in fact, the Congress significantly reduced taxes on nominal capital income, so the effective tax rates cited in the text exceed current effective tax rates on capital income.
- ⁵⁸ To calculate real accrual income, the authors adjusted national income account (NIA) income in several ways. They indexed straight-line depreciation, used constant-dollar FIFO inventory accounting, and added into income the real gain on net financial liabilities. (John Shoven and Jeremy Bulow, "Inflation Accounting and Nonfinancial Corporate Profits: Financial Assets and Liabilities," in Brookings Papers on Economic Activity, 1:1976, pp. 39-42.)

ation could outweigh its advantages and recommend against it.⁵⁹ On the other hand, many years of even relatively low inflation can seriously distort the measurement of real income. Moreover, high rates of inflation can arise unexpectedly, and when inflation is worse than anticipated, as in the late 1970s, an unindexed tax base can cause serious problems.

Even within the economics profession, there is wide disagreement as to whether base indexation is desirable on balance. Many economists now advocate indexing the income tax base, in spite of the complexity of doing so, but some also favor repealing the current savings and investment tax incentives so that tax would be imposed on the closest practical approximation to real economic income. Others believe that the complexity of indexing plus the serious distortions that result if the base is not indexed provide compelling reasons to abandon income as the tax base and to tax consumption instead. (This approach is discussed in Chapter VI.) Yet others oppose indexing, because of its complexity and out of concern that it would fuel inflation or be enacted without repeal of the current tax preferences for saving and investment, leaving the income tax with more distortions overall than it currently contains.

⁵⁹ Of course, opinions differ as to what rate of inflation would justify base indexation. Economist Martin Bailey advocated base indexing if inflation is expected to remain above 5 percent a year, and occasionally exceed 10 percent a year. (Martin Bailey, "Inflationary Distortions and Taxes," in Henry Aaron, ed., Inflation and the Income Tax, p. 316.) Even if inflation subsides or prices become stable, the effects of previous inflation continue to be felt for many years in depreciation, capital gains, and inventory accounting. (See T. Nicolaus Tideman and Donald Tucker, "The Tax Treatment of Business Profits under Inflationary Conditions," in Inflation and the Income Tax, pp. 33-80.)

